Mary Shirley on Oliver Williamson's "The Lens of Contract: Applications to Economic Development and Reform"

This is an excellent paper, which I believe clearly shows the importance of designing reforms based on excruciatingly detailed understanding of rules, norms and processes at the microeconomic level. As he puts it, the challenge is not just "to become familiar with the conceptual moves that attend the lens of contract reasoning" it is also "to acquire transaction specific knowledge about the nature of economic aid and development." I agree entirely with his contract lens, as will quickly become apparent to anyone who reads my own work.

However, at least judging from my World Bank experience, aid is driven by organizational incentives that make it hard to respond to the lessons of this paper. In my 21 years at the World Bank I found that our internal incentives lead to three persistent design flaws:

1. Best practice infatuation
2. Ignorance is bliss
3. Laying on of hands

Best practice infatuation

By this I mean the belief that economic rules and policies that worked well in one country can be imported into another country with minimal adaptation.

Here let me pause for a small digression. Another disease of aid design is "short termism." This leads to a claim of best practice for models that are at most a year old, and may even be in the planning stage. For example, I worked on 1983 World Development Report on the management of development. Not one of the success stories cited in the boxes proved to be sustainable ten years later. This is a problem not only with WDRs, but with many other best practice models. However, for the rest of the discussion I will assume that best practice is indeed a proven success.

New Institutional Economics tells us clearly that best practice in one country cannot be simply imported to another and expected to work equally well. As Doug North has pointed out: "…the common imposition of a set of rules will lead to widely divergent outcomes in societies with different institutional arrangements." (North 1990) North gives the example of the US constitutions adopted in most of Latin America with very different results. The same rules, but different enforcement mechanisms, different norms, different mental models of the actors led to very different outcomes.

Levy and Spiller coin the nice term "goodness of fit" to describe this problem in regulation (Levy and Spiller 1994). As they say, "…the notion that the first-best solution to the problem of the design of regulatory rules is readily transferable across countries is mistaken."

Coase in his Nobel Prize lecture provided another example, that of Eastern Europe (Coase 1992) "These ex-communist countries are advised to move to a market economy, and their leaders wish to do so, but without the appropriate institutions no market economy of any significance is possible." As Williamson points out in the paper under consideration, the economists and aid advisors who designed the privatization program in Russia were, like many other economists and advisors, convinced that the issue was one of the assignment of property rights and that the future would take care of itself. A greater appreciation of the shortfalls of the institutional environment in Russia and the hazards of ex post implementation might have led to a very different approach. (Williamson 2000) Williamson asks if the flaws in the privatization program could have been predicted ex anti, and the answer is yes. Others and I did so.

Even if aid agency workers are sensitized to institutional issues, they rely on technical advisors who are not likely to take goodness of fit into account. Not only is it not easy or clear how to do so, but outside advisors are unlikely to be informed about what local conditions are, and are naturally motivated to design reforms based on what they know. For example, Coopers and Lybrand designed the market rules for electricity trading in Colombia based on the rules of the England and Wales power pool. There some doubt that these rules were suited to the geological circumstances in Colombia with its decentralized hydro-based system, as compared with England and Wales' thermal powered system. But there is no doubt that the complexity of the system was ill suited for a developing country context and opened the door for a lot of interference by the legislature. (Millán 2001)

Ignorance is Bliss

Even aid workers do want to take institutions into account, they often don't know much about institutions in the countries they work on and they may not know what they don't know. I have found the design of aid projects is often A-historical – the focus is on institutions in place, but not how they emerged over time. Consider, for example, the history of Russia. The dominance of the Communist Party over the sort of competitive interest groups that we take for granted -- producer groups, consumer groups, workers unions, media, church, other special interests – was it reasonable to assume that when the party was removed from power in Russia, that these groups would suddenly function as they do in representative Western democracies? These were some of the reason why, as Mancur Olson described in his article of that name, the transition from communism is so difficult.

Knowledgeable aid workers may be familiar with a country's formal institutions, but less likely to understand the informal institutions. It is inevitable that it will be hard for outsiders to know a country's norms and unwritten rules. The citizens know their informal institutions, but they may not value that knowledge, or may not want to communicate it to outsiders, even when they work for the same aid agency.

Another problem is the incentives. Aid agency staff may be motivated to ignore or downplay local norms when they conflict with taking action. Consider, for example, Indonesia, where corruption widely regarded by Bank staff as "benign" (versus perverse forms of corruption elsewhere), until the Asian crisis occurred and Indonesia imploded.

Laying on of Hands

Employees in aid agencies have a strong bias towards activism and optimism, thanks to both employer selection and self selection. Optimism and activism are important criteria for hiring people to work on development, and only those who have those traits will want to work on development for any length of time.

Ordinarily these biases are a good thing, but when institutions were accepted as important, aid activists began writing about institution building and institutional change. The view that we could alter institutions to suit our projects was irresistible given incentives in development institutions. But in fact an unhappy message of NIE is that it is hard to change institutions, and as Williamson points out in his paper, we cannot ignore the influence of initial conditions.

Can outsiders change a country's institutions? Obviously yes – Napoleon did, but he didn't do it with aid. The experience with aid directed at institutional change has not been a happy one. For example, a great deal of funding has wasted on trying to build rule of law: aid for judicial training, court buildings, libraries, commercial courts, new laws re judicial tenure, selection, etc. In his paper Williamson cites Davis and Trebilcock's analysis that most of this effort has not worked (Davis 2001).

What about providing support to local reformers to change their institutions? Frequently they too are not attuned to changing local institutions and their reforms disappear almost without a trace. I joined the World Bank when Belaunde was the President of Peru, and I doubt that many of our projects to support his reforms made much of an impact because he was focused on building roads and dams, and not attuned to changing Peru's institutions.

Argentina is a better example of the problems that local reformers have if they are not interested or able of changing institutions. Under Menem a cadre of local intellectuals who had been trained in workings of a market economy in the West, but not well trained in institutions, were responsible for designing the reforms. They famously used a currency board to stabilize the inflation rate and attract investors. Yet, as a forthcoming book by Pablo Spiller and Mariano Tomassi makes clear, Argentina's constitutional and political institutions give power to provincial governors and local party bosses, not to anyone who cares about the federal government deficit. The fixed exchange rate was inevitably unsustainable because the deficit would fall prey to tragedy of commons. Argentina's weak court system also meant that rule of law would never be strong, so investor confidence would disappear with currency board

The fact is we don't know how to make broad-brush changes in institutions, although we may be able to change rules and norms at a more micro level. Institutional flaws will eventually destroy reforms unless the reformers are backed a powerful dictator, as in Chile.

Why do we see these design flaws in aid agencies?

In his paper Williamson asks about the informal and formal rules of aid bureaucracies. My experience is that there are strong incentives to ignore institutions and try to import best practice, or to treat them as malleable, and little incentive to understand institutions in the necessary but excruciating detail. Again I can boil it down to three problems:

1. Short-term focus. We work on projects, and our focus is on what can be done in the time frame of project. Even if we are remaking the Russian economy, it needs to be done in five or six years, at most a decade. There is no incentive to take a slow molecular approach. The staff in Bank are rotated every three to five years, and there are strong career penalties for those who take more than five years. So we want success before we leave the assignment. Success is defined as getting the project approved, perhaps as getting it implemented, but not as sustainability over long run. In the long run the staff member is on another assignment. Early my career a colleague advised me to move more rapidly, before my mistakes catch up with me.
2. Work with governments. This leads to a bias towards assuming that government can be made to reform properly, since there is no time to wait around for a new government. Staff are not rewarded for saying a government is not reform minded since this causes a lot of problems to the project pipeline. And typically one doesn't want to consider politics except as an obstacle that project must be designed to withstand. Williamson's point that sometimes the losers from reform have legitimate complaints is also often ignored, as are the problems of working with democracies, despite much lip service to contrary. Aid workers are always concerned not to put at risk the discussion of future projects with governments by pushing too hard for the current project.
3. Activisim bias. I have already talked about the fact that it is natural that activists are the kind of people attracted to aid, and type an aid agency wants to hire. Internal incentives reinforce this activism. Internal incentives work on the assumption that all

problems have a solution that aid can address. The reward is for projects to the board, not for development. It is hard to impossible to hold staff accountable for development or for mistakes of projects gone bad, since it impossible to control for other factors determining outcomes. So there is not downside to making mistakes, and few rewards for doing an extensive analysis of institutional details that might slow or halt projects and call operating assumptions into question.

Can these incentive problems be overcome? In my remarks on Steve Knack's paper I will give you an example of institutional analysis and leave it for you to judge. Is there another approach? I have retired from the World Bank and started the Ronald Coase institute to purse a different strategy to institutional change.

The Ronald Coase Institute

I don't have time to go into it, but at the Ronald Coase Institute we have a different approach. We believe that the obstacles to development are largely institutional in nature. More and more development agencies have recently discovered the importance of institutions. But unlike them, we don't believe that outsiders can engineer institutional change through a combination of money and advice, much like you would build a dam to change the flow of a river. Our model is to build the capacity of local scholars to understand their own country's institutions and devise realistic solutions to bring down transaction costs, solutions that will work in their own institutional setting, and to help them communicate their findings to policy makers and teach it to future opinion leaders. Our goal is to help countries develop the intellectual capital they need to seize political opportunities, change their institutions, and create opportunities for people to improve their lives.

Field Design

I recommend that the field design use Williamson's lens of contract. I specify how to do this in my peer review of Knack's paper.

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